

**THE LAW REGULATING THE INVESTMENT OF PUBLIC
EMPLOYEE RETIREMENT SYSTEM FUNDS**

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The Law Regulating the Investment of Public Employee Retirement System Funds

The Montana Constitution

Article VIII, section 13, of the Montana Constitution provides (emphasis added):

"Section 13. Investment of public funds and public retirement system and state compensation insurance fund assets. (1) The legislature shall provide for a unified investment program for public funds and public retirement system and state compensation insurance fund assets and provide rules therefor, including supervision of investment of surplus funds of all counties, cities, towns, and other local governmental entities. Each fund forming a part of the unified investment program shall be separately identified. Except as provided in subsections (3) and (4), no public funds shall be invested in private corporate capital stock. The investment program shall be audited at least annually and a report thereof submitted to the governor and legislature.

(2) The public school fund and the permanent funds of the Montana university system and all other state institutions of learning shall be safely and conservatively invested in:

(a) Public securities of the state, its subdivisions, local government units, and districts within the state, or

(b) Bonds of the United States or other securities fully guaranteed as to principal and interest by the United States, or

(c) Such other safe investments bearing a fixed rate of interest as may be provided by law.

(3) Investment of public retirement system assets shall be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of an enterprise of a similar character with similar aims. Public retirement system assets may be invested in private corporate capital stock.

(4) Investment of state compensation insurance fund assets shall be managed in a fiduciary capacity in the same manner that a prudent expert acting in a fiduciary capacity and familiar with the circumstances would use in the conduct of a private insurance organization. State compensation insurance fund assets may be invested in private corporate capital stock. However, the stock investments shall not exceed 25 percent of the book value of the state compensation insurance fund's total invested assets."

For purposes of investment of the assets of the various public retirement systems, a key provision in this section is the first sentence of subsection (3). A person acting in a fiduciary capacity transacts business for or handles the assets of another person, must exercise a high degree of good faith in doing so, and must manage the business or assets for the sole benefit of the other person. The second sentence of subsection (3), allowing public retirement system funds

to be invested in private corporate capital stock, is another key provision. Subsection (3) became effective on January 1, 1995.

Article VIII, section 15, of the Montana Constitution, provides:

"Section 15. Public retirement system assets. (1) Public retirement systems shall be funded on an actuarially sound basis. Public retirement system assets, including income and actuarially required contributions, shall not be encumbered, diverted, reduced, or terminated and shall be held in trust to provide benefits to participants and their beneficiaries and to defray administrative expenses.

(2) The governing boards of public retirement systems shall administer the system, including actuarial determinations, as fiduciaries of system participants and their beneficiaries."

This section was adopted by the voters and became effective on January 1, 1995. The provision that the assets "shall be held in trust" imposes a duty similar to the duty of one who acts in a fiduciary capacity.

This section is implemented by 19-2-409, MCA, which provides:

"19-2-409. Plans to be funded on actuarially sound basis -- definition. As required by Article VIII, section 15, of the Montana constitution, each system must be funded on an actuarially sound basis. For purposes of this section, "actuarially sound basis" means that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. For a defined benefit plan, the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years. For the defined contribution plan, the full actuarial cost is the contribution defined by law that is payable to an account on behalf of the member."

Administration of the systems and investment of their funds

The Public Employees' Retirement Board (PERB) established by 2-15-1009, MCA, administers the public employees', highway patrol officers', game wardens' and peace officers', firefighters' unified, volunteer firefighters', municipal police officers', sheriffs', and judges' retirement systems, except that the Board of Investments handles the investments of the systems' funds. See Title 19, chapter 2, part 5, 19-17-201, and 19-17-302, MCA. The Teachers' Retirement Board (TRB) established by 2-15-1010, MCA, administers the Teachers' Retirement System (TRS), except that the Board of Investments handles the investments of the systems' funds. See 19-20-201 and 19-20-501, MCA.

MCA provisions specific to the public employees', highway patrol officers', game wardens' and peace officers', firefighters' unified, municipal police officers', sheriffs', and judges' retirement systems

Under 19-2-501, MCA, a separate pension trust fund is established for each retirement plan within each of these systems. Under 19-2-503, the PERB administers the system, the Department of Administration deposits in the State Treasury all funds received by the board, and the Board of Investments invests the funds. Section 19-2-504, MCA, also provides that the pension trust funds of the retirement systems must be invested by the Board of Investments, as part of the unified investment program described in Title 17, chapter 6, part 2, MCA. That section further provides that all income earned on any assets constituting a part of the pension trust funds must be paid into the appropriate pension trust funds as received and that the pension trust funds may be commingled for investment purposes, but separate accounts must be maintained for each system. Restrictions on the use of funds are contained in 19-2-505, MCA, which provides:

- "19-2-505. Restrictions on use of funds.** (1) Except as provided in this section, a member or an employee of the board or the board of investments may not:
- (a) have any interest, direct or indirect, in the making of any investment or in the gains or profits accruing from the pension trust funds;
 - (b) directly or indirectly, for the member or employee or as an agent or partner of others, borrow from the pension trust funds or deposits;
 - (c) in any manner use the pension trust funds except to make current and necessary payments that are authorized by the board;
 - (d) become an endorser or surety as to or in any manner an obligor for investments for the pension trust funds; or
 - (e) engage in a transaction prohibited by section 503(b) of the Internal Revenue Code.
- (2) The assets of the retirement systems, including the assets of retirement accounts, may not be used for or diverted to any purpose other than for the exclusive benefit of the members and their beneficiaries and for paying the reasonable administrative expenses of the retirement systems administered by the board.
- (3) The assets of the retirement systems remain in trust until a warrant has been negotiated or an electronic funds transfer has been deposited in accordance with law.
- (4) Retirement benefits not claimed within 5 years after the member's death are forfeited and revert to the retirement system trust fund.
- (5) This section does not prevent the administration of an investment alternative within the defined contribution plan to the same extent that all other investment alternatives within the defined contribution plan are managed."

MCA provisions specific to the volunteer firefighters' system

Section 19-17-106(1) establishes a pension trust fund for the volunteer firefighters'

system, and subsections (2) through (4) provide:

"(2) The pension trust fund must be funded on an actuarially sound basis. For purposes of this subsection, 'actuarially sound basis' means that contributions must be sufficient to pay the full actuarial cost of the fund. The full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years.

(3) Except as provided in this section, a member or an employee of the department or the board of investments may not:

(a) have any interest, direct or indirect, in the making of any investment or in the gains or profits accruing from the pension trust fund;

(b) directly or indirectly, for the member or employee or as an agent or partner of others, borrow from the pension trust fund or deposits;

(c) in any manner use the pension trust fund except to make current and necessary payments that are authorized by the board; or

(d) become an endorser or surety as to or in any manner an obligor for investments for the pension trust fund.

(4) The assets of the pension trust fund may not be used for or diverted to any purpose other than for the exclusive benefit of members, their surviving spouses, their dependent children, and qualified fire companies and for paying the reasonable administrative expenses of administering this chapter."

Under 19-17-201, MCA, the PERB administers the pension trust fund, the Department of Administration deposits in the State Treasury all money received by it for the fund, and the Board of Investments invests the funds.

MCA provisions specific to the teachers' system

Under 19-20-201, MCA, the Teachers' Retirement Board established in 2-15-1010, MCA, administers the teachers' retirement system. Section 19-20-501, MCA, provides that the board members are the trustees of all money collected by the system and shall provide for the financial administration of the money as provided in Article VIII, section 15, of the Montana constitution. That section also provides that the money must be invested by the Board of Investments and that the State Treasurer is the custodian of the system's money and of the securities in which the money is invested. Restrictions on use of the money are contained in 19-20-502, which provides:

"19-20-502. Restrictions on use of money. (1) A member of the retirement board or an employee of the board may not:

(a) have an interest, directly or indirectly, in the gains or profits of any investment of money of the retirement system, except as provided in this section;

(b) directly or indirectly, for the member or employee or as an agent, in any manner use the money or deposits of the retirement system except to make current and necessary

expenditures authorized by the retirement board; or

(c) become an endorser or surety or in any manner an obligor for money loaned by or borrowed from the retirement system.

(2) The assets of the retirement system may not be used for or diverted to any purpose other than for the exclusive benefit of the members and their beneficiaries and for paying the reasonable expenses of administering the retirement system.

(3) The board may not engage in a transaction prohibited by section 503(b) of the Internal Revenue Code.

(4) The assets of the retirement system must remain in trust until a warrant for the assets has been paid or an electronic funds transfer of system assets has been made in accordance with law."

The unified investment program

Section 17-6-201, MCA, provides:

"17-6-201. Unified investment program -- general provisions. (1) The unified investment program directed by Article VIII, section 13, of the Montana constitution to be provided for public funds must be administered by the board of investments in accordance with the prudent expert principle, which requires an investment manager to:

(a) discharge the duties with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity with the same resources and familiar with like matters exercises in the conduct of an enterprise of a like character with like aims;

(b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so; and

(c) discharge the duties solely in the interest of and for the benefit of the funds forming the unified investment program.

(2) (a) Retirement funds may be invested in common stocks of any corporation.

(b) Other public funds may not be invested in private corporate capital stock. "Private corporate capital stock" means only the common stock of a corporation.

(3) (a) This section does not prevent investment in any business activity in Montana, including activities that continue existing jobs or create new jobs in Montana.

(b) The board is urged under the prudent expert principle to invest up to 3% of retirement funds in venture capital companies. Whenever possible, preference should be given to investments in those venture capital companies that demonstrate an interest in making investments in Montana.

(c) In discharging its duties, the board shall consider the preservation of purchasing power of capital during periods of high monetary inflation.

(d) The board may not make a direct loan to an individual borrower. The purchase of a loan or a portion of a loan originated by a financial institution is not considered a direct loan.

(4) The board has the primary authority to invest state funds. Another agency may not invest state funds unless otherwise provided by law. The board shall direct the investment of state funds in accordance with the laws and constitution of this state. The board has the power to veto investments made under its general supervision.

(5) The board shall:

(a) assist agencies with public money to determine if, when, and how much surplus cash is available for investment;

(b) determine the amount of surplus treasury cash to be invested;

(c) determine the type of investment to be made;

(d) prepare the claim to pay for the investment; and

(e) keep an account of the total of each investment fund and of all the investments belonging to the fund and a record of the participation of each treasury fund account in each investment fund.

(6) The board may:

(a) execute deeds of conveyance transferring real property obtained through investments. Prior to the transfer of real property directly purchased and held as an investment, the board shall obtain an appraisal by a qualified appraiser.

(b) direct the withdrawal of funds deposited by or for the state treasurer pursuant to 17-6-101 and 17-6-105;

(c) direct the sale of securities in the program at their full and true value when found necessary to raise money for payments due from the treasury funds for which the securities have been purchased.

(7) The cost of administering and accounting for each investment fund must be deducted from the income from each fund."

Subsection (2) of 17-6-203, MCA, requires a separate investment fund, which may not be held jointly with other funds, for money pertaining to each retirement system.

Section 17-6-211, MCA, provides:

"17-6-211. Preference to in-state investment firms -- commitment agreement with board of housing. (1) The board of investments shall endeavor to direct its portion of the state's investment business to those investment firms and/or financial institutions which maintain offices in the state and thereby make contributions to the state economy. Further, due consideration shall be given to investments which will benefit the smaller communities in the state. The state's investment business will be directed to out-of-state firms only when there is a distinct economic advantage to the state of Montana.

(2) The board may enter into a commitment agreement with the board of housing at the time of an issue of bonds or notes by the board of housing providing for the purchase at a specified future date, not to exceed 15 years from the date of the issue, of all or any portion of the amount of mortgage loans purchased with the proceeds of the issue. The board of investments may charge reasonable fees for any commitment and may agree to purchase the mortgage loans on terms that in the judgment of the board of investments provide a fair market rate of return to

the purchasers."

Employee's pension benefit rights as a constitutionally protected contract

Because increasing employer and/or employee contributions, reducing benefits, or a combination of the two is often considered as a means of addressing a shortfall in the funds available to pay benefits, this section will address those matters.

There is no problem with the legality of increasing the amount that an employee must contribute to the system, and of course neither is there a problem with increasing the contribution of the employer. Nor is there a problem with reducing benefits payable to new employees. However, decreasing the benefits payable to current employees or retired employees presents a problem, because the promised benefits are part of a contract between the employee (or retiree) and the state.

Section 19-2-502(2), which relates to all systems except the teachers' and volunteer firefighters' systems, provides:

"(2) Benefits and refunds to eligible recipients are payable pursuant to a contract as contained in statute. The contract is entered into on the first day of a member's covered employment and may be enhanced by the legislature. Unless specifically provided for by statute, the contract does not contain revisions to statutes after the time of retirement or termination of membership."

Section 19-20-501(6), which relates only to the teachers' system, is a similar provision and provides:

"(6) Benefits and refunds to eligible recipients are payable pursuant to a contract as contained in statute. Unless specifically provided for by statute, the contract does not contain revisions to statutes after the time of retirement or termination."

Article II, section 31, of the Montana Constitution provides that "No ex post facto law nor any law impairing the obligation of contracts . . . shall be passed by the legislature".

Under a line of Montana Supreme Court cases dating back almost 60 years, an employee's or retiree's accrued pension benefit rights are a contract with the state and cannot be altered by the state to the employee's detriment during employment or after termination of employment.

The key case, and the first in the line of cases, is *Clarke v. Ireland*, 122 Mont. 191, 199 P.2d 965 (1948). At the time that plaintiff teacher retired in 1945 she had not reached the age required for the receipt of retirement benefits. Under the statutory plan, the teacher applied for withdrawal of her contributions to the annuity savings fund created by the statute, including interest on her

contributions, which the teacher was entitled to under a 1937 law. This law was amended in 1945 to provide that the teachers were no longer credited with the interest and that the interest went elsewhere. The court held that the "contract between the individual teacher on the one hand and the school district and the state on the other is entitled to the same protection of the Federal and Montana Constitution offered a contract between individuals". The court also held that "in attempting to change the terms of the contract and deprive the contributing teacher of the interest she was entitled to under the contract, the Montana legislature violated" the contracts clauses of the state and federal constitutions.

In *Coate v. Omholt*, 203 Mont. 488, 662 P.2d 591 (1983), the court invalidated, among other provisions of a statute, a provision requiring forfeiture of part of the pay of a member of the judiciary who did not follow the statute's procedures and time limits for reaching judicial decisions. The court held that the forfeiture provision violated the state and federal constitution clauses prohibiting the impairment of contracts. The court favorably cited *Olson v. Cory*, 27 Cal.3rd 203, 164 Cal. Rptr. 217, 609 P.2d 991 (1980), a case in which the California Supreme Court interpreted those clauses as they applied to the judiciary's right to a salary set by statute. The California court stated:

"Public employment gives rise to certain obligations which are protected by the contract clause of the Constitution. Promised compensation is one such protected right. Once vested, the right to compensation cannot be eliminated without unconstitutionally impairing the contract obligation. When agreement of employment between the state and public employees have been adopted by governing bodies, such agreements are binding and constitutionally protected."

It is no stretch to include in the "obligations which are protected by the contract clause" the obligation to provide benefits contractually promised by a pension plan contract and to argue that just as *Coate v. Omholt* protects those obligations relating to salary it also protects those obligations relating to pension benefits, thus echoing the protection provided by *Clarke v. Ireland*.

At the time of *MPEA v. Office of the Governor*, 271 Mont. 450, 52 St. Rep. 523, 898 P.2d 675 (1995), the state employee compensation system included a series of grades, with steps within each grade. The higher the grade, and step within a grade, the higher the compensation. The directors of two executive branch departments informed their employees that steps lost in the past when an employee was promoted more than one grade, because of a practice of taking away steps when an employee was promoted more than one grade, would be reinstated. The Governor prohibited the departments from doing so. The court held that the directors' promise did not create a contract because the employees gave nothing of value in return for the promise and, therefore, there was no contract obligation to which the contracts clauses of the state and federal constitutions could apply. The court thus impliedly recognized the application of those contract clauses to a state employee's contracts with the state, including the pension contract.

In *Gulbrandson v Carey*, 272 Mont. 494, 52 St. Rep. 843, 901 P.2d 573 (1995), retired Montana

Supreme Court Justice Gulbrandson argued that he was entitled to a Judges' Retirement System benefits increase provided by a bill that was signed by the Governor, and thus became law, before he retired, even though the section of the bill that provided the increase did not take effect until after he retired. He alleged that denial of the increase impermissibly impaired his pension contract in violation of the Montana Constitution's contract clause. The court reasoned that under the three-part test that the court applies to determine whether legislation violates the contracts clause, the initial inquiry is whether the law has operated as a substantial impairment of the contract, the question in Gulbrandson's case being whether his pension contract guaranteed him the benefit of the increase contained in the bill. The court concluded that the contracts clause was not violated because the law in effect upon his retirement governed his benefits and the benefits increase did not take effect until after his retirement. By considering and answering Gulbrandson's contracts clause argument, the court again impliedly accepted the principle that the contracts clause applies to benefits under a pension contract, because if the clause does not so apply the court could have simply said so and refused to consider Gulbrandson's argument.

Furthermore, in making its determination, the court in the *Gulbrandson* case applied the case of *Leonard v. City of Seattle*, 503 P.2d 741 (Wash. 1972), in which the Washington court refused to allow the forfeiture of a retired police officer's pension under a statute enacted after the officer's retirement and providing for forfeited pension rights upon a felony conviction.

Gulbrandson also argued that his equal protection rights were violated because the bill created impermissible classifications of retired judges and singled him out by placing him in a class of persons who retired between the time that the bill became law and the time that the bill took effect. Applying the rational basis test, the court held that there was no equal protection violation. The two classes are judges who retired before the bill's effective date and judges who retire after the bill's effective date. Not all classifications are an equal protection violation, and the mere creation of classifications is not a violation. A purpose of the bill was to provide an incentive for judges to remain in service by increasing their retirement benefits for years of service in excess of 15 years. That is a legitimate governmental interest and is a rational basis for the bill. The court also held that it was not unreasonable or arbitrary that the effect of the bill is to provide a higher benefit for a judge who retires after the bill takes effect than for a judge who retires before the bill takes effect, even though the two judges have the same number of years and months of service.

Conclusion

To sum up the above:

--The pension plans are administered by the Public Employees' Retirement Board, except that the teachers' plan is administered by the Teachers' Retirement Board.

--The two boards must manage the plans' funds in a fiduciary capacity and hold the funds in trust

for the benefit of plan participants.

--The plans' funds are deposited in the State Treasury.

--The Board of Investments invests the plans' funds, as part of a unified investment program, and acts in a fiduciary capacity in doing so and holds the funds in trust for the benefit of the plan participants.

--Employees and retirees have a contract right to benefits and the right is protected by the contract clauses of the state and federal constitutions.